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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1965

No. 623

GEORGIA RAILROAD AND BANKING COMPANY,
*Petitioner,*

*v.*

UNITED STATES OF AMERICA,
*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

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## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

TO THE HONORABLE THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your petitioner, Georgia Railroad and Banking Company, respectfully requests this Honorable Court to issue a writ of certiorari to the United States Court of Appeals for the Fifth Circuit to review the decision and judgment of that court entered in the above entitled case on June 30, 1965, pursuant to the opinion reversing on two issues the judgment of the United States District Court for the Southern District of Georgia in favor of petitioner and directing the entry of judgment for the United States.

## Opinion Below.

The findings of fact and opinion of the District Court (R. 166-184) are unreported. The opinion of the Court of Appeals (R. 193-215) is reported in 348 F. 2d 278.

## Jurisdiction.

The judgment of the Court of Appeals was entered on June 30, 1965 (R. 217). The jurisdiction of this Court is invoked under the provisions of 28 U. S. C. 1254.

## Questions Presented.

1. *Dividends-received deduction.* Which is entitled to the 85% dividends-received deduction in 1954, petitioner, the lessor-owner of stocks whose investment (capital) produced the income from which the dividends were paid, or its lessee which collected them and which paid to petitioner the larger amount paid under the lease?

2. *Depreciation.* Petitioner having been required to charge off part of the March 1, 1913 basis of certain stocks upon distribution of a remainder interest therein to its stockholders (Section 312(a)(3), Internal Revenue Code, 1954), is the retained part of the basis recoverable through depreciation (amortization) as an offset to the annual income payments derived from its leasehold interest?

## Statutes and Regulations Involved.

The pertinent statutory provisions directly involved are Sections 167(a) and (g), 243 and 312(a)(3), Internal Revenue Code (1954); these and other statutory provisions

together with the income tax regulations indirectly involved are printed in the appendix, *infra*, pp. i-viii.

## Statement.

1. Dividends-Received Deduction.

The issue here relates to the partial exemption provided by Section 243(a) of the Internal Revenue Code (1954) as it affects dividends paid in 1954 by certain railroad corporations on stocks leased by petitioner, the owner, to other corporations which collected the dividends. The lease was executed in 1881 for a term of 99 years (R. 167). The leased assets consisted of railroad properties, including bonds and stocks of certain railroads (R. 167). The leased stocks were registered in the name of "Louisville and Nashville" as trustee for itself and the Atlantic Coast Line Railroad (R. 167-168).

On March 1, 1913 and at all times thereafter, 9,361 shares of the capital stock of Atlanta & West Point Rail Road Company and 15,000 shares of the capital stock of The Western Railway of Alabama were subject to the 1881 lease as amended (R. 167). Of the annual payments of $600,000 for the use of all of the leased properties, $164,520 represented the amount held properly allocable for the use of the leased stocks ($46,320 for the 9,361 shares of Atlanta & West Point and $118,200 for the 15,000 shares of The Western Railway of Alabama) (R. 168). During the taxable period here involved, a fractional part of a year, the dividends paid by the leased corporations to the lessees amounted to $84,361, which was less than the portion of the annual payments, $127,854, which the lessees were required to pay to petitioner for the use of the leased stocks during such period (R. 168, 171).

The earnings of the respective railroads, Atlanta & West Point and Western Railway of Alabama, were greater in 1880 than the allocable annual payments under the 1881 lease, but averaged somewhat less during the five years 1877 to 1881 than such payments (R. 14, 15). The lessees were required to return the leased properties in good condition and unimpaired in value at the end of the lease term but were entitled to keep the earnings, if any, not needed to satisfy their obligation to the owner (Stip. Ex. 2, pp. 9-10).

The district court considered the evidence relative to the cross payments (the dividends collected by the lessees and the larger amounts paid by them to petitioner) and entered findings and conclusions stating, in substance, (a) that petitioner was the beneficial owner of the shares, and (b) that in effect the lessees which collected the dividends paid them over constructively to petitioner as part of the annual payments provided in the lease (R. 171, 172). Based on these premises the trial court concluded that petitioner, whose investment in the dividend-paying companies produced the income from which the dividends were paid, rather than its lessees, was entitled to the benefits of the statutory exemption (deduction) (R. 177-178). Accordingly, that court held that as between the lessor-owner and the lessees of securities yielding dividends, the former is the true owner,—the tree on which the fruit grows (R. 178).[1] The district court also pointed out that a contrary decision would carry with it the unusual result that the lessees would be entitled not only to a deduction for the full amount of the annual rent but also to a further partially duplicating deduction to the extent of 85% of the dividends collected and remitted to the owner of the securities (R. 178).

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(1) *Lucas* v. *Earl*, 281 U. S. 111 (1930).

The circuit court rejected the trial court's findings and overruled its conclusions, holding in substance that petitioner had divested itself of beneficial ownership of the leased securities and that the dividends in question belonged, therefore, to the lessees (R. 209).

2. Depreciation.

In 1954, petitioner distributed to its stockholders as a dividend the future interest (reversion) in part of its leased securities but kept the present interest which included the right to the income from the lease for the remaining term (25¾ years) (R. 168-169). The Treasury Department ruled that the reversionary interest was taxable at its fair market value to the stockholder-distributees; petitioner charged off against its surplus, as required by Section 312 of the Code, the adjusted basis of the segment thus distributed (R. 169, 173). The district court made findings of fact to the effect that the dividend severed petitioner's basis (March 1, 1913 fair market value) into two parts, one part going to the stockholders and the other being retained (R. 173). The trial court also found that the retained present interest in the securities constituted property held for the production of income, that it constituted a wasting asset with a useful life of 25¾ years (the unexpired term of the lease), and that petitioner was entitled to recover the basis of this interest through depreciation (amortization) allowances as an offset to the income from the property (R. 169, 170, 173, 174).

The circuit court ignored or rejected the above findings of the trial court. It pointed out that corporate stock is a nondepreciable asset and asserted the proposition that the leasehold interest of the lessor could constitute a depreciable asset only if it had a separate investment in

it (R. 210-211). The reviewing court expressed the opinion that the mere fact that a basis exists ($1,596,624, 63.57% of the March 1, 1913 basis) and the further fact that the property is exhaustible do not confer depreciability, and that depreciability cannot be conferred by a voluntary gratuitous division of nondepreciable property into two segments (R. 212-214). Although the court does not challenge the trial court's finding that the dividend was distributed for business reasons (R. 168), its reversal of the decision below is based on the manner in which severance of the property, with the resulting reduction of basis, was effected (R. 212). The court in effect holds that the disposition of part of the taxpayer's property by dividend results in the loss of basis, not only of the part distributed, but also of the undistributed remainder.

## Reasons for Granting the Writ.

I. Dividends-Received Deduction.

1. *The Circuit Court has decided a Federal question in a way in conflict with a prior decision of this Court.*

In *Rupe Investment Corporation* v. *Commissioner*, 266 F. 2d 624 (1959), the Fifth Circuit held that beneficial ownership is requisite to the one claiming the dividends-received credit and that a record owner who is not the beneficial owner of the stock is not entitled to such credit.[2] Other Federal decisions are in accord. *DeGuire* v. *Higgins*, 159 F. 2d 921 (CA-2, 1947); *Moore* v. *Commissioner*, 124 F. 2d 991 (CA-7, 1941); *Wilson* v. *Commissioner*, 27 T. C. 976 (1957); *Steel Improvement & Forge Company* v. *Commis-*

(2) Both petitioner and respondent urged in the district court that the decision in this case depended upon the answer to the question, which of them was the real beneficial owner of the leased securities and entitled therefore to the dividends in question (R. 175).

*sioner*, 314 F. 2d 96 (CA-6, 1963); *Miller* v. *Commissioner*, 247 F. 2d 206 (CA-7, 1957).

The instant decision of the Fifth Circuit that the dividends in question belonged to the lessee-railroads is predicated on its determination that petitioner had divested itself of beneficial ownership of the properties leased to the Louisville & Nashville and Atlantic Coast Line railroads. In *Wright* v. *Louisville & Nashville Railroad Company*, 236 U. S. 287 (1915), however, we submit that this Court held exactly the contrary.

The majority opinion by Justice Holmes in the *Louisville & Nashville Railroad Company* case construed the identical lease here involved and held that under Georgia law the lessor (petitioner herein) was the real owner of the leased properties. The Court held, therefore, that the state of Georgia could levy against the properties thus leased to the Louisville & Nashville and Atlantic Coast Line railroads, the lessees in possession, only such *ad valorem* taxes as it might properly impose upon the lessor. Justice Holmes' opinion pointed out that the leasing of railroad properties by the owner, entitled to a partial exemption from state taxes, to lessees not so entitled, did not give the state the right to tax the properties to the lessees in possession. This exemption of the lessor was also held applicable to improvements and rolling stock substitutions made by the lessees which, under the lease, became the property of the lessor immediately. The Court observed (p. 690) that the lessees, not being domiciled in Georgia, were "not taxable there for stock and bonds of other companies *merely appearing to be owned by them*" (we infer that this reference was to the leased stocks registered in the name of Louisville & Nashville).[3] (Italics supplied.)

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(3) The *Louisville & Nashville* decision of this Court was cited by petitioner both in its oral and written argument but is not mentioned in the circuit court's opinion.

Also, in *Greene County, et al.* v. *Wright*, 126 Ga. 504 (1906), the Supreme Court of Georgia held that Georgia Railroad and Banking Company was not relieved of its liability for taxes on the Western Railway of Alabama stock by reason of the lease and transfer of the stock certificates to its lessee, the Louisville & Nashville Railroad Company. The court held that the stock's situs for taxation as intangible personal property was Augusta, Georgia, the residence of petitioner, the corporate owner. Thus the status of Georgia Railroad and Banking Company as the real beneficial owner of the leased properties including the securities assigned to the Louisville & Nashville and Atlantic Coast Line railroads has been adjudicated and recognized by both state and Federal courts for over 50 years.

The position of respondent and of the lessees in the instant proceedings (the lessees were allowed to present oral and written argument as *Amici Curiae*) appears in conflict with the position of the lessees which was sustained by the Federal courts in the prior litigation. There, the lessees asked the Federal courts to protect them from the taxing power of the state and wrapped about themselves the cloak of exemption of their lessor, claiming relief from state taxes by virtue of the fact that the properties belonged, not to them, but to their lessor. Having thus succeeded in obtaining the benefits of a partial exemption from state taxes on the ground that petitioner was the real owner of the leased properties, the lessees ought not now to prevail in their claim to Federal tax benefits predicated on the ground that they are, after all, the beneficial owners of the leased stocks. Since the dividends-received deduction is allowable either to petitioner or to its lessees but not to both, respondent is a mere stakeholder; this was pointed out by the trial court (R. 175). We submit that the same

Federal courts which handed down the prior decisions ought not to reverse the position taken then for state tax purposes in this proceeding where Federal taxes are involved.[4]

*2. The Circuit Court's disregard of the well settled rule that the findings of the Trial Court shall not be set aside unless clearly erroneous, presents an appropriate case for the exercise by this Court of its powers of supervision.*

The district court weighed the evidence, both oral and documentary, and made findings that petitioner was the beneficial owner of the leased stocks. The reviewing court substituted its own view squarely in conflict, namely, that petitioner had divested itself of beneficial ownership of the leased shares (R. 209). The opinion asserts that the restrictions on the lessees (they were obligated to make the annual payments and to return the leased properties, railroads and shares, in as good condition as when they were leased and "unimpaired in value") were relatively minor! We submit that the trial court's findings of fact and inferences were not clearly erroneous even if, as a matter of original valuation and contrary to our view, the opposite findings and inferences substituted by the reviewing court could reasonably have been adopted by the trial judge. Accordingly, the rejection of such findings and substitution of others inconsistent therewith should not be allowed to stand. Rule 52, Federal Rules of Civil Procedure; *McCaughn* v. *Real Estate Land Title & Trust Company*, 297 U. S. 606 (1936); *McAllister* v. *United States*, 348 U. S. 19 (1954); *United States* v. *National Association of Real*

(4) The Supreme Court's decision in the *Louisville & Nashville* case affirmed the decision of the Fifth Circuit on this question (201 Fed. Rep. 1023) which in turn affirmed the decision of the district court (199 Fed. Rep. 454).

*Estate Boards*, 339 U. S. 485 (1950); *United States* v. *Yellow Cab Company*, 338 U. S. 338 (1949); *United States* v. *Gypsum*, 333 U. S. 364 (1948); *Epperson* v. *Connecticut Fire Insurance Company*, 314 F. 2d 486 (CA-10, 1963); *Lundgren* v. *Freeman*, 307 F. 2d 104 (CA-9, 1962); *Darter* v. *Greenville Community Hotel Corporation*, 301 F. 2d 70 (CA-4, 1962); *Lawlor* v. *National Screen Service Corporation*, 270 F. 2d 146 (CA-3, 1959); *Central Railway Signal Co., Inc.* v. *Longden*, 194 F. 2d 310 (CA-7, 1952); *Bush* v. *Remington Rand, Inc.*, 213 F. 2d 456 (CA-2, 1954).

In this connection, it appears that the Fifth Circuit's refusal to apply the assignment of income doctrine of *Lucas* v. *Earl, supra*, and the constructive income (attribution) principles of *United States* v. *Joliet & Chicago Railroad Company*, 315 U. S. 44 (1942), to the facts of this case was predicated on the erroneous premise that the petitioner had divested itself of beneficial ownership of the leased stocks.

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A brief recapitulation may be helpful. In keeping with the principles established in prior litigation, the district court determined that the lessee railroads which collected the dividends on the leased shares of stock in effect paid them over to the lessor-owner. It is settled, of course, that income is attributed and taxed generally to the one who creates it (or to the one whose capital creates it). *Lucas* v. *Earl, supra*; *Helvering* v. *Clifford*, 309 U.S. 331 (1940); *Helvering* v. *Eubank*, 311 U.S. 122 (1940); *United States* v. *Joliet & Chicago Railroad Company, supra*. (The latter case involved a perpetual lease; it was held that the lessor-owner of the leased assets was chargeable with the rent even though it never received a penny thereof, the rent moneys having been paid directly to the lessor-stockholders.) The amount of the annual payments, $164,520,

for the right to collect the income from the leased shares was less than the income which the leased properties were producing at the time the contract was executed (R. 15-16, 168). In the case of such cross payments, the courts often treat the transactions, taxwise, as involving the payment or receipt of only the net amount.

The trial court's application of the rule which exalts substance over form to the instant case would seem particularly appropriate here where the parties anticipated the cross flow of the payments (dividends from lessor's stocks to the lessees and annual fixed payments to the lessor). *Frelbro Corporation* v. *Commissioner*, 315 F. 2d 784 (CA-2, 1963). In this connection, attention is invited to the observation of the district judge that assignments such as this, "if recognized for tax purposes, would open avenues of tax avoidance through trafficking in dividends received deductions" (R. 177).

In conclusion and by way of summary, we submit the following:

(a) The circuit court has ignored or disregarded the prior adjudication of the rights and obligations of the parties to the 1881 lease by this Court which in 1915 approved the decisions of the Fifth Circuit and of the district court holding in effect that petitioner was the beneficial owner of the leased assets and securities.

(b) The circuit court has ignored or disregarded the prior adjudication of the rights and obligations of the parties to the 1881 lease by the Supreme Court of Georgia which in 1906 established that petitioner was the beneficial owner of, and therefore subject to personal property tax on, the stocks leased to the Louisville & Nashville and Atlantic Coast Line railroads.

(c) The Federal courts, constituting the judicial branch of the United States Government, having

denied to the state of Georgia in the 1915 litigation the right to tax the leased assets as the property of the lessees, the attempt of respondent now to predicate Federal taxes on the premise that the lessees are beneficial owners of the leased securities should not be sanctioned.

(d) The district court's findings and conclusions which are consistent with the decisions of the Federal and state courts in the prior proceedings should not be rejected as "clearly erroneous" inasmuch as the issue whether the lessor or its lessees were the beneficial owners of the securities involves largely questions of fact and the inferences to be properly drawn therefrom.

II. Depreciation.

The depreciation issue relates to only a part of the 9,361 shares of Atlanta & West Point stock and 15,000 shares of Western Railway of Alabama stock under lease by petitioner to the Louisville & Nashville and Atlantic Coast Line railroads (R. 167). The 1954 dividend resulted in the distribution to the petitioner's stockholders of reversionary rights to 7,000 of the Atlanta & West Point shares and 12,180 of the Western Railway of Alabama shares (R. 168-169). This dividend did not terminate petitioner's right to continue to receive the full amount of the annual payments from its lessees for the remainder of the lease period; the portion of the basis allocable to this retained interest amounted to $1,596,624 (R. 169, 170). The appellate court agreed with the district court that the dividend constituted income to the distributee stockholders (they were taxable on the property distributed at its fair market value, Section 301, I. R. C.); it agreed also that the dividend required adjustment of petitioner's basis (an allocable part of the basis of the entire property had to be

charged off to eliminate the distributed property, Section 312, I. R. C.). It disagreed, however, with the district court's decision that the effect of the dividend, the retained portion of the property involved being a wasting asset, should be recognized for depreciation purposes.

1. *The Circuit Court has decided a Federal question in a way in conflict with applicable decisions of this Court; the effect of the decision is to deny to petitioner its constitutional rights.*

The Fifth Circuit stated that "the mere fact that a basis exists on the taxpayer's books and that the property is exhaustible does not alone confer depreciability". It is submitted that this doctrine, i.e., that a taxpayer may be entitled to a statutory basis in the case of a wasting asset but that he may not be entitled to recover it through depreciation allowances, is fraught with mischief. This Court held in *United States* v. *Ludey*, 274 U. S. 295 (1927) (unanimous opinion by Justice Brandeis):[5]

> "The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part of the plant which has been sold."

The concept of basis is as old as the income tax laws. Section 167(g) of the Code stipulates that the basis for depreciation of wasting assets shall be the same as that provided in computing gain from sales of property. Sections 1011, 1012, 1014 and 1053 of the Code spell out with particularity the basis to which taxpayers are entitled. In this case it is the March 1, 1913 value of the undivided property

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(5) Although the opinion in the *Ludey* case referred to "cost", a footnote explained that as to properties acquired before March 1, 1913, the term "cost" was used as meaning their value as of March 1, 1913, that value being higher than the original costs.

(the shares of stock subject to the 1881 lease). Section 312(a)(3) of the Code required an adjustment of petitioner's basis to charge off such portion as was allocable to the reversionary interests in the property distributed in 1954.

The crux of the issue presented here, therefore, is whether petitioner is entitled to recover the basis of a wasting asset as an offset to the income realized therefrom. Petitioner's property (leased stocks) had a fair market value of $2,511,600 on March 1, 1913; it was required to charge off $914,976 of that sum representing that part of the basis allocable to the interest distributed to its stockholders. Thus petitioner was left with a present interest, including the leasehold, having a basis of $1,596,624. This was a terminable interest the income from which could be expected to continue for 25¾ years from the date of the dividend.

The doctrine propounded by the circuit court that wasting assets may have a basis but that recovery of such basis may not be allowable through depreciation is untenable. As noted above, this Court decided the basic principle otherwise in *United States* v. *Ludey, supra,* holding that depreciation is the method by which the basis of wasting assets is recoverable. In the case of property acquired after March 1, 1913, the basis is cost; in the case of property acquired before that date it is cost or March 1, 1913 value, whichever is greater. The decision of the circuit court violates this basic concept and denies to petitioner rights given to it by Congress. Any appreciation in value which took place before March 1, 1913 is recoverable untaxed; it represents part of the taxpayer's invested capital when the Income Tax amendment to the Constitution was passed. Refusal to allow recovery of such capital tax-free is to deny to petitioner its constitutional rights. This Court

has repeatedly recognized the principle set forth in the *Ludey* case that depreciation allowances are a means of recovering basis. See, e.g., *Weiss* v. *Wiener*, 279 U. S. 333 (1928), and *Massey Motors, Inc., et al.* v. *United States*, 364 U. S. 92 (1960).

2. *The decisions of the circuit courts of appeal are in conflict on the question whether recovery of the statutory basis of wasting assets through depreciation must be allowed; further clarification by this Court is needed.*

Despite this Court's decisions discussing the theory of depreciation deductions as the method provided for recovery of basis, the United States courts of appeal for the several circuits are in disagreement whether the basis provided by statute must in all cases be allowed. The instant decision of the Fifth Circuit presents a case in which the court accepts the trial judge's findings that the taxpayer has a basis and the amount of the basis but denies that such basis is recoverable through depreciation allowances. An examination of the opinion discloses that the court was influenced by decisions in which recovery of the statutory basis through depreciation was not allowed.

Since the leased securities here involved were acquired in the ordinary course of business prior to March 1, 1913, it is submitted that petitioner is a purchaser for value. Accordingly, the following cases establish the applicable principles: *World Publishing Company* v. *Commissioner*, 299 F. 2d 614 (CA-8, 1962);[6] *1220 Realty Company* v.

(6) The World Publishing Company decision of the Eighth Circuit contains an analysis of the conflicting decisions on the subject of depreciable interest, with particular reference to the alleged necessity of an investment, for depreciation purposes, in the case of property acquired by inheritance. In addition to its discussion of the cases, the court cites the "substantial criticism" by eminent tax authorities including Rabkin and Johnson, Lurie

*Commissioner*, 322 F. 2d 495 (CA-6, 1963); *Dab* v. *Commissioner*, 255 F. 2d 788 (CA-2, 1958); *Millinery Center Building Corporation* v. *Commissioner*, 350 U. S. 456 (1956), aff'g 221 F. 2d 322 (CA-2, 1955). See also *Reisinger* v. *Commissioner*, 144 F. 2d 475 (1944), in which the Second Circuit pointed out that the values passing to an heir (statutory basis) were treated as his investment in the property and held that they were, therefore, recoverable through depreciation.

This is not a case involving depreciation of property paid for by others (respondent has never denied an investment by petitioner when it originally acquired the leased shares of stock). Therefore, the cases relied upon in the Fifth Circuit's opinion are inapposite. These include such cases as: *Detroit Edison Company* v. *Commissioner*, 319 U. S. 98 (1943) (utility's claim to depreciation of service lines constructed by its customers); *Commissioner* v. *Moore*, 207 F. 2d 265 (CA-9, 1953), *cert. den.* 347 U. S. 942; *Schubert* v. *Commissioner*, 286 F. 2d 573 (CA-4, 1961), *cert. den.* 366 U. S. 960; and *Friend* v. *Commissioner*, 119 F. 2d 959 (CA-7, 1941), *cert. den.* 314 U. S. 673. (The last three cases involved claims to depreciation of the statutory basis (values at date of death) of property acquired by inheritance; in the *Schubert* case, the court commented on the irreconcilable conflict between the circuits on this issue.)

It is submitted that the basis provided by statute in the case of exhaustible interests in property is recoverable. In the event of a sale, the basis is allowable as an offset to

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(New York University Institute on Federal Taxation, 1960), Rubin (65 Harvard Law Review, 1952), and Mertens (The Law of Federal Income Taxation). Since the instant case does not involve property acquired by inheritance, the cases and authorities on the basis of such property to the acquiring taxpayers is not directly in point; the instant case represents, however, an extension of the error involved in many of those decisions to a new field.

the selling price; in case the property is not sold, the recovery takes the form of depreciation which is an offset to the income from the property. It is believed that the conflicts between the circuits and the resulting confusion are attributable to a failure on the part of some of the courts to recognize this underlying principle.

3. *The Circuit Court has decided an important question of Federal law which has not been but should be settled by this Court.*

*The argument hereunder assumes, contrary to our view (point 1, supra, p. 13), that the depreciation issue is not controlled by this Court's decision in the* Ludey *case, supra.*

The Fifth Circuit has compared petitioner's retained property interest after the dividend distributed by petitioner in 1954 to property acquired by donative transfers, such as property acquired by inheritance (R. 213-214, fn. 26). This peculiar analogy has resulted in the treatment of petitioner which retained the greater part of the property (bundle of rights) involved in the 1954 dividend as if it were a donative transferee which acquired a terminable interest in property without a basis.

In the case of a dividend, the distributees report and are taxed on the market value of the property which they receive. The corporate distributor charges off an equitable part of its basis. Had petitioner distributed its entire interest in the property, the leased shares of stock, the stockholders would have been taxed on the fair market value of such shares and the entire basis would have been eliminated from petitioner's assets. The retention of the right to collect the income for 25¾ years represented substantially greater value than the remainder interest (reversion) distributed to the stockholders. It seems plain that sever-

ance by a dividend which is taxable to the stockholder-recipients is analogous from the transferor-owner's standpoint to a sale. That is the reason for Section 312(a)(3) requiring a charge off of the basis of the distributed assets.

By way of analogy, the appellate court discusses the application of Section 273 of the Code and cites *Codman* v. *Miles*, 28 F. 2d 823 (CA-4, 1928), *cert. den.* 278 U. S. 654 (R. 213-214, fn. 26). Section 273 denies depreciation deductions in respect of life or terminable interests acquired by gift, bequest or inheritance. The *Codman* case holds that a life tenant is taxable on the income which he derives from gift property and that he is not entitled to deductions for exhaustion. It seems plain that neither Section 273 nor the *Codman* decision have any application to the instant case which involves property (retained interest in leased stocks) acquired by an investor in the ordinary course of business.

The reasons for the prohibition in Section 273 against the allowance of depreciation to a donee life tenant are found in Sections 1014 of the Code and Sections 1.1014-4 and 1.1014-5 of the regulations. These so-called uniform basis provisions require that the statutory basis of an undivided property acquired from a decedent be equitably apportioned if there are several beneficiaries. Thus, if one beneficiary receives a life estate and another the remainder, it is necessary for tax purposes to provide a reasonable method of allocating the basis of the entire property between them.

The solution to this problem provided in the regulations is simply to require an apportionment between the beneficiaries at the time one of them disposes of his interest. Pending such disposition, the life tenant and remainderman are in effect joint owners of the entire basis. The severance of basis may happen shortly after the beneficiaries acquire their respective interests in the property, it may not happen

until years later, and, again, it may never happen. Obviously, the interest of the life tenant is greater immediately after the decedent's death and grows progressively less with the lapse of time. The remainderman's interest, on the other hand, is less immediately after the decedent's death and grows progressively greater. The regulations, therefore, provide that the basis shall remain intact between the joint beneficiaries until one of them disposes of his interest, thus making an allocation necessary. The apportionment between the parties in the case of such a severance takes into account the extent of the life tenant's interest at that time. A donee beneficiary who has acquired a terminable interest in property but not the fee may not deduct depreciation since the entire basis belongs jointly to him and to the remainderman. Unless one of the beneficiaries disposes of his interest, the entire basis will eventually belong to the remainderman when his reversion ripens into possession.

Although the Fifth Circuit's reliance upon Section 273 of the Code prohibiting depreciation in the case of donative transfers to more than one beneficiary is misplaced, we submit that the Section is helpful. The proper analogy afforded by this statute is between the effect of the instant dividend and severance of property interests and the effect of a disposition of a jointly held interest by one of the co-beneficiaries of a decedent's estate. Here, the basis to petitioner of its stocks remained unaffected so long as it continued to own both the present interest (the leasehold) and the future interest (the reversion). The same is true in the case of beneficiaries having a joint basis. Here, upon disposition of petitioner's reversionary interests by dividend, the severance required an appropriate allocation of the basis. Section 312, I.R.C. This allocation is similar to that required by Sections 1.1014-4 and 1.1014-5 of the

regulations when one of two or more beneficiaries of a decedent's estate disposes of his interest in property the basis of which has not previously been allocated.

Petitioner having distributed a part of its property in 1954 by a dividend has irrevocably lost the portion of the basis allocable to the interest acquired by its stockholders. After the severance thus accomplished, the basis of the retained property does not increase or decrease except as the property depreciates. Neither does the basis of the stockholder-distributees change with the lapse of time.

The circuit court has given great weight to the manner in which the petitioner disposed of part of its property in determining the deductibility of the basis (through depreciation allowances) allocable to other property not disposed of. We submit that this is not controlling; in fact, we doubt its relevancy. Corporate taxpayers have the inherent right to dispose of interests in property by sale, gift or dividend. Although such transactions have widely differing tax consequences, the basis of property thus disposed of should not be confused with the basis of that retained.

The Fifth Circuit is here extending depreciation rules applicable to property acquired by gift to property acquired in the normal course of business, a portion of which was disposed of by dividend. There is no authority for this in the statutes or regulations; it flies in the face of logic.

It follows from the foregoing analysis that the reviewing court has misconceived the principles applicable to dividend distributions of property. There is no authority in the law or the decided cases for rejecting the plain meaning of the applicable statutes (Section 312(a)(3) of the Code) which provide for the allocation of basis when part of the taxpayer's property is distributed. The basis of the retained part remains on the taxpayer's books and

should be recoverable over the period in which the asset produced income. This period is specifically determinable and is a term of years ending in 1980. The recovery, therefore, should take the form of depreciation allowances as income is realized from this wasting asset.

## Conclusion.

Both issues presented in this petition relate to continuing problems which will presumably recur annually until 1980. The district court's decision holding that petitioner was the beneficial owner of the stocks under lease to the Louisville & Nashville and Atlantic Coast Line railroads is in accord with the evidence; the substitution by the appellate court of its view that petitioner had divested itself of beneficial ownership is contrary to the evidence. Moreover, the decision of the appellate court that the lessees were the beneficial owners (and therefore entitled to the dividends-received deduction) is in conflict with an earlier decision of this Court adjudicating, in connection with state taxes, that the lessor (and not the lessees) was the real owner of the property under the identical lease here involved. The findings of the trial court were not "clearly erroneous".

The district court's decision on the second issue holding that petitioner was entitled to depreciation (amortization) allowances in respect of its retained leasehold interest in shares of stock after the distribution for business reasons of a remainder interest (reversion) to its stockholders was also correct; here again the trial court's findings have been disregarded. The circuit court has misconceived the applicable law and has applied principles deemed relevant to the basis of inherited property or to transfers in which the transferee of a terminable interest is not per-

mitted depreciation since he acquires no basis separate from that of the transferee of the remainder interest. The Fifth Circuit having recognized the findings of the trial court that petitioner's retained interest in the property has a basis (the March 1, 1913 value) and that the property is a wasting asset, it follows that the basis allowed by statute is recoverable through depreciation allowances.

WHEREFORE, your petitioner respectfully prays that its petition for a writ of certiorari be granted on both issues.

Respectfully submitted,

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# APPENDIX.

## Internal Revenue Code of 1954.

Sec. 165. Losses.

(a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of Deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

* * * * * *

Sec. 167. Depreciation.

(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * * *

(g) Basis for Depreciation.—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

* * * * * *

Sec. 243. Dividends Received by Corporations.

(a) General Rule.—In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:

(1) 85 percent, in the case of dividends other than dividends described in paragraph (2) or (3);

* * * * * *

Sec. 273. Holders of Life or Terminable Interest.

Amounts paid under the laws of a State, a Territory, the District of Columbia, a possession of the United States, or a foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time.

Sec. 301. Distributions of Property.

(a) In General.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) Amount Distributed.—

(1) General Rule.—For purposes of this section, the amount of any distribution shall be—

(A) Noncorporate Distributees.—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

* * * * * *

(c) Amount Taxable.—In the case of a distribution to which subsection (a) applies—

(1) Amount Constituting Dividend.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * * * *

(d) Basis.—The basis of property received in a distribution to which subsection (a) applies shall be—

(1) Noncorporate Distributees.—If the shareholder is not a corporation, the fair market value of such property.

* * * * * *

Sec. 311. Taxability of Corporation on Distribution.

(a) General Rule.—Except as provided in subsections (b) and (c) of this section and section 453(d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of—

(1) its stock (or rights to acquire its stock), or

(2) property.

* * * * * *

Sec. 312. Effect on Earnings and Profits.

(a) General Rule.—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—

* * * * * *

(3) the adjusted basis of the other property, so distributed.

* * * * * *

Sec. 316. Dividend Defined.

(a) General Rule.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year

without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. . . .

* * * * * *

Sec. 1011. Adjusted Basis for Determining Gain or Loss.

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

Sec. 1012. Basis of Property—Cost.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

Sec. 1014. Basis of Property Acquired from a Decedent.

(a) In General.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold,

exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under either section 2032 or section 811(j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections.

* * * * * *

Sec. 1053. Property Acquired Before March 1, 1913.

In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subtitle, adjusted (for the period before March 1, 1913) as provided in section 1016, is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

**Income Tax Regulations**

§ 1.61-6 Gains Derived From Dealings in Property.—(a) *In general.*—Gain realized on the sale or exchange of property is included in gross income, unless excluded by law. For this purpose property includes tangible items, such as a building, and intangible items, such as goodwill. Generally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. The specific rules for computing the amount of gain or loss are contained in section 1001 and the regulations thereunder. When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction

and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of. This rule may be illustrated by the following examples:

*Example (1).* A, a dealer in real estate, acquires a 10-acre tract for $10,000, which he divides into 20 lots. The $10,000 cost must be equitably apportioned among the lots so that on the sale of each A can determine his taxable gain or deductible loss.

*Example (2).* B purchases for $25,000 property consisting of a used car lot and adjoining filling station. At the time, the fair market value of the filling station is $15,000 and the fair market value of the used car lot is $10,000. Five years later B sells the filling station for $20,000 at a time when $2,000 has been properly allowed as depreciation thereon. B's gain on this sale is $7,000, since $7,000 is the amount by which the selling price of the filling station exceeds the portion of the cost equitably allocable to the filling station at the time of purchase reduced by the depreciation properly allowed.

* * * * * *

§ 1.167(a)-3 Intangibles.—If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. . . .

* * * * * *

§ 1.1014-4. Uniformity of basis; adjustment to basis.—

* * * * * *

(b) *Multiple interests.* Where more than one person has an interest in property acquired from a decedent, the

basis of such property shall be determined and adjusted without regard to the multiple interests. The basis for computing gain or loss on the sale of any one of such multiple interests shall be determined under § 1.1014-5. Thus, the deductions for depreciation and for depletion allowed or allowable, under sections 167 and 611, to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property not only in the hands of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under sections 167 and 611, both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 262. Similarly, adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable. . . .

§ 1.1014-5. Gain or loss.—(a) *Sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent.* (1) The gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is assignable to the interest sold or otherwise disposed of. The adjusted uniform basis is the uniform basis of the entire property adjusted to the time of sale or other disposition of any such interest as required by sections 1016 and 1017. The uniform basis is the unad-

justed basis of the entire property determined immediately after the decedent's death under the applicable sections of part II, subchapter O, chapter 1 of the Code. The proper measure of gain or loss resulting from a sale or other disposition of an interest in property acquired from a decedent is so much of the increase or decrease in the value of the entire property as is reflected in such sale or other disposition. Hence, in ascertaining the basis of a life interest, remainder interest, or other interest which is sold or otherwise disposed of, the uniform basis rule contemplates that proper adjustments will be made to reflect the change in relative value of the interests on account of the passage of time. Where a remainder interest is subject to a life interest in one person only, the factors set forth in the table which appears at the end of this subparagraph shall be used in determining the basis of the life interest or the remainder interest in the property at the time such interest is sold. The basis of the life interest or the remainder interest is computed by multiplying the uniform basis (adjusted to the time of the sale) by the appropriate factor. In the case of the sale of a life interest or a remainder interest, the factor used is the factor which appears in the life interest or the remainder interest column of the table opposite the age (at the time of the sale) of the person at whose death the life interest will terminate.

* * * * * *